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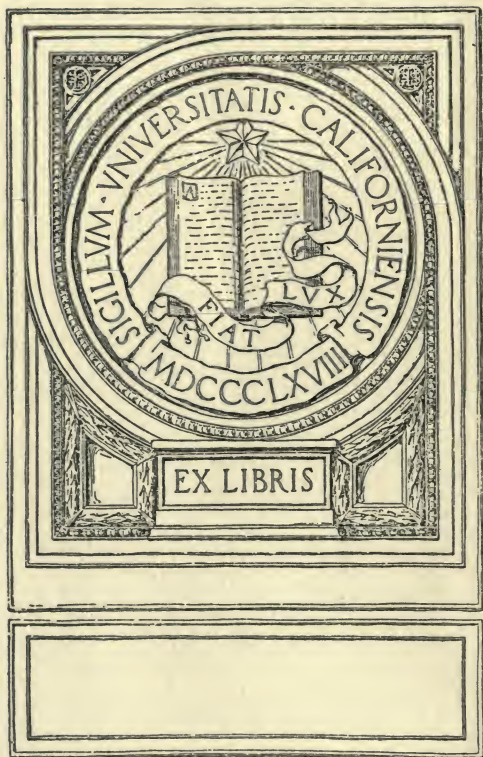
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THE
MONETARY
OUTLOOK.

The Garton Foundation.

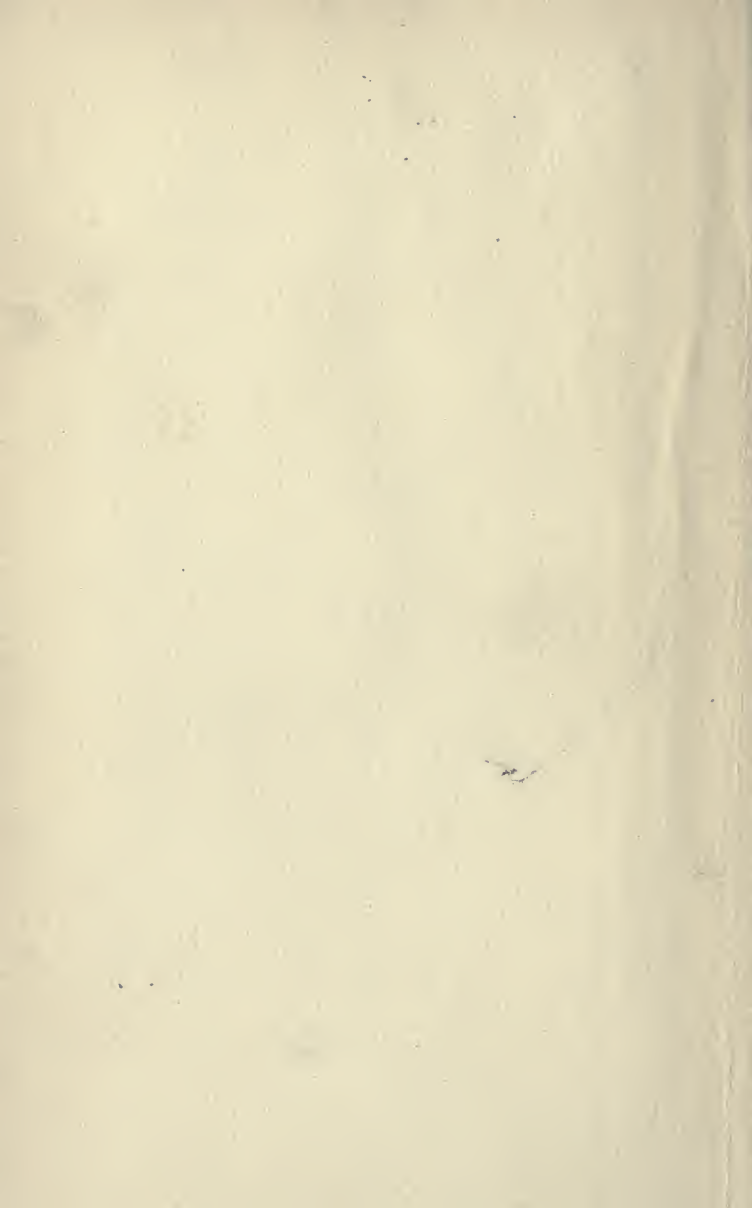
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THE MONETARY OUTLOOK.

Introduction.

FOR about six months now (November, 1920) the rise of prices, which occurred during the War and which started again about March, 1919, has ceased, and there has been a fall of wholesale prices. The cost of living, however, as measured by retail prices of foods, has continued to rise, and, in spite of some fall in other retail prices, there is no certainty that the mere cessation of the increase in the cost of living is yet in sight; still less can it be said that any substantial fall is imminent. At the moment, however, the general impression is that the period of inflation has come to an end. The check in the increase of wholesale prices is obvious, and it is accompanied by a check in trade activity. Unemployment is increasing, and that fact is the one which absorbs attention.

If we contemplate the future over a period of years, however, as we can look back over the past for a period of years, it is still an open question whether the depreciation of the value of money will continue or not. It

might have been anticipated from past experience that a general upward movement of prices would not go on year after year without any check, and what is happening now affords no sufficient evidence that there is anything more than a temporary check in a movement which may once more set in if the necessary steps are not taken to prevent it. Attention should therefore be directed in the first place to a consideration of the causes of this general movement, rather than to the immediately felt phenomena of what may be only a temporary pause.

Some of the methods which might be adopted to prevent the continuance of inflation will be discussed, and some consideration will be given to the question whether there is any prospect of a more satisfactory control of currency. There is not only the question whether further inflation can be stopped but the question whether anything can be done to mitigate those fluctuations of employment which are largely connected with the monetary system.

Accompanying the rise of prices, there has been a weakness of foreign exchange with countries from which we have to buy a large part of our food and raw materials—the United States, the Argentine Republic and

India, more particularly. This weakness still continues.

There is also still an enormous State Debt, including a floating debt of over a thousand millions, and the prospect of early maturity of part of the debt which is not of such short period as to be classed with the floating debt.

That these phenomena are connected with one another scarcely needs emphasis, but the nature of the connection has given rise to a certain amount of difference of opinion, and this leads to divergent views regarding the measures which should be adopted in the future. It is not irrelevant, therefore, even if our main interest is in the question what should be done now, and in the future, to pay some attention to the way in which the present situation has arisen.

Inflation during the War.

There have been, during the War, and to a considerable extent also since hostilities ceased, simultaneously increasing (1) Government loans, (2) Bank deposits, (3) Treasury notes, (4) Profits and (5) Wages. The facts are stated in this order without necessarily implying that they occur in this order. It is generally agreed, however, that at all

events during the actual progress of the War, Government borrowing took the lead and might properly be considered the main cause of the whole series of occurrences. The Government, being in urgent need of means to pay men and buy materials in continually increasing quantity, and continually in excess of what could readily be obtained by taxation, obtained credit in the first place from the Bank of England. This was to a considerable extent pure creation of new purchasing power, with which the Government bought what it required, and the public, not having their own purchasing power, reckoned in terms of money, diminished to the extent to which the Government's purchasing power was increased, competed for the smaller quantity of goods and services which were left, and tended to keep on sending up prices. In addition to the actual increase of money, there was to a considerable extent a decrease in the goods available for purchase. If some prices had not been controlled they would undoubtedly have risen far more than they actually did, but no control could prevent the growing volume of purchasing power from having a considerable effect.*

* It may be remarked, in view of various erroneous statements which have been made, that the inflation of prices was not due

During this period, the issue of Currency notes might properly be considered, from one point of view, as a result rather than as an originating cause of the rise of prices. The increasing purchasing power spread from the cheque-using classes to the wage-earning classes, employers had to ask for more actual

to the fact that the goods produced during the War consisted, to a considerable extent, of things like shells and cartridges which were destroyed. It does not matter whether the newly created money was applied to the production of cartridges which were used up, or of rifles which endure. The point is that the goods, when produced, were not sold to the public and paid for out of individual income, so as, on the one hand, to enable the Government to repay its advances from the Bank of England, and, on the other hand, to withdraw the expenditure of individual income from other classes of goods. It is incorrect to suggest that if by a similar process of creating new money, the Government had produced, say, houses, town-halls, railways, etc., because goods as well as money would have been produced in increased quantity, there would have been no inflation of prices. If, by some such process, the Government, for a few years, caused capital goods of this nature to be produced in much greater quantity than usual, there would have been, on the one hand, a diminution of other production, and on the other hand, an increase in money incomes, which would not, for the most part, have been applied to the purchase of the houses, halls, railways, etc. Most people would only pay out of their income for the current use of such things. There is no reason to suppose that they would add greatly to their savings and purchase, in abnormal degree, the capital values of houses, etc. They would endeavour to spend the increased money income in buying increasing quantities of such things as clothing, boots, butter, etc., and as the supply of these things would be less rather than more, prices would be sent up. The inflation money, once created and used for such purposes, would have to be maintained in existence for a long period of time, incomes and prices would be inflated, and additional legal-tender currency would have to be available.

cash to pay wages, and the Banks had to be provided with what was necessary. The issue of Currency notes in increasing quantities was, however, fundamentally necessary to a continuance of the whole system. The Banking system could not have continued for more than a few months to support the inflation of credit if there had not been, in the background, the knowledge that legal tender notes would be forthcoming when necessary.* This cycle, once started, however, has a momentum which carries it on for some time after the originating cause—buying by the Government in excess of its receipts from taxation and sale of goods—has ceased. Rising prices are like a fire, which, as it burns, raises the temperature of the surrounding material and produces conditions favouring an extension of the fire. The elementary principle is the same as that discovered at a time of speculation in a particular security or class of securities. The classic instance is that of the South Sea bubble, where a number of people were persuaded, individually, that the shares of

* It is also, no doubt, true that if legal tender notes had been issued in the same quantity without any Government borrowing, and without any war, their issue would have led, but perhaps in a longer period of time, to credit expansion and a great rise of prices and money incomes.

the South Sea Company would rise in value and sought to buy them. Because of this buying movement the price went up the faster, and appeared more than to justify the expectations. Hence more people were convinced that these shares were a good thing and hurried to buy, the price again responded and appeared to justify the expectations. That, however, was an early experiment in a limited field, and it is not necessary to infer that all such movements must end in a sensational collapse. The parallel is merely an illustration of the natural infectiousness of a state of rising prices until something happens to stop it. The causes of the stoppage and the nature of the subsequent events may be many and various, according to circumstances, but there is always a tendency for the opposite trend also to be infectious and self-perpetuating, and this phase is liable to be accompanied by unpleasant consequences.

In ordinary circumstances, under a gold standard such as existed before the War, an expansion movement is arrested in course of time because the Bank of England finds its stock of gold becoming unduly diminished. This is partly due to the fact that more wages are paid out and more cash is therefore required by the public and the other Banks ;

and partly to export of gold. With rising money incomes, people naturally buy more foreign goods of all kinds and they buy for home consumption some British goods which would otherwise be exported. There is thus a tendency for increase of imports, and there may also be a diminution of exports, either absolutely or relatively to the value of imports, and this leads to exports of gold.

The Bank of England, in such circumstances, has to raise its rate and so check the inflation of prices.

The present situation differs from the normal in that gold is no longer necessary for internal payments. Currency notes have taken the place of gold, and there is no natural limitation of their supply. It appears simple enough, at first sight, to say that the Government can stop the increase of the supply of notes now that the War is over, and can re-call those already issued. That is not at all easy, however, and, although the Government some time ago announced that there was to be a maximum limit to the fiduciary issue, the effect of the existing issues had not then exhausted itself, and it still remains to be seen whether the policy announced can be strictly adhered to. Assuming, however, for the present, that this policy will be adhered

to, some consideration should be given to the question why prices and wages continued rising although the actual volume of notes had not increased very much since the end of 1918, and the increase which had taken place had been partly offset by the setting aside of Bank of England notes to the amount of over eighteen millions as cover for the Currency notes. The facts are that the volume of actually issued Currency notes is not the full measure of the multiplication of the basis on which bank credit can be increased, and that the banks had not, at the termination of hostilities, and still have not, made full use of the possibilities of expansion. The call for the use of these possibilities is a gradual process which is still going on. The hundreds of millions of Treasury Bills represent a contingent possibility of issuing further legal tender notes.

*Normal Process of Inflation and Deflation of
Credit under Banking System.*

It is evident from discussions which have taken place in the press and elsewhere, that there is still a good deal of obscurity about the working of the currency and banking system, and even about the *modus operandi* of

inflation during the War and subsequently. At the risk of being tedious, therefore, it is important to see whether apparent differences of opinion can be reconciled.

We shall get to the root of the differences of opinion if we contrast two different ways in which the ordinary business of bankers is liable to be described and see how the apparent difference is to be reconciled.

To the banker, in his ordinary business, just as to other people, money is something indestructible, which he receives as deposits and of which he lends out a considerable proportion, but not the whole. He has to watch the daily flow of money into his bank—mainly, of course, by way of cheques payable by other banks, and partly actual cash—and the daily flow-out—mainly by cheques drawn in favour of people who bank at other banks. If he sees that the flow-in is exceeding the flow-out, he considers that he has more money to lend, and may be prepared to reduce the rate of interest in order to get something rather than nothing for the surplus. Alternatively, however, he may decide to strengthen his cash reserve by not lending some of this money. If £100,000 is paid in to the credit of his customers, by cheques payable by other banks, and he decides not

to lend this out again, his balance at the Bank of England will be strengthened to the extent of £100,000. He does not think of that money as being "wiped out." It is not wiped out, for him. He has got it and can use it again some day if he likes.

Similarly, in the reverse case, the banker does not regard himself as "creating" money if he decides that he can afford to lend more than he has been doing. He may find the demand for loans increasing, and without stopping any loans which he otherwise would have made, he may decide that he can afford to lend another £100,000. He may reasonably consider that he is lending £100,000 of his existing balance at the Bank of England. He may reasonably expect that that money will soon be paid out to customers of other banks and that his balance at the Bank of England will be reduced to £100,000 less than it would have been had he decided not to grant that loan.

It is not surprising, therefore, that many bankers tend to resent the suggestion that they are in any way responsible for "inflation" or "manufacture of money." They feel that they only try to find a use for money which is deposited with them and which comes from they know not whence; and when the

reverse process is in operation, as at the present moment, they protest against complaints by traders that they are deliberately "restricting" loans. They say they have to refuse many requests because they have not got enough to lend to meet all the demands.

Contrast this attitude with the statement of theoretical writers. Mr. Hartley Withers in his "Meaning of Money" has a chapter entitled "The Manufacture of Money." Mr. Hawtrey, in his "Currency and Credit" (page 19) states that "the banker creates the means of payment out of nothing." Lord Cunliffe's "Committee on Currency and Foreign Exchanges after the War," though, being bankers, they do not use these expressions, simply state, after showing how a Ways and Means Advance leads to an addition to the cash resources of the other banks, that those other banks "are in a position to make advances to their customers of an amount equal to four or five times the sum added to their cash reserves," without explaining how it can be done.

Both these ways of putting things are, in their way, correct. It may be that no banker (excluding the case of the Bank of England during the period of heavy Government borrowing) lends money which he has not already received, that he does not consciously

create or destroy a single pound, yet the banking system as a whole does inflate and deflate the volume of money, varying both the flow per unit of time and the amount in existence at any moment of time. These variations are mainly connected with variations in the cash basis—the volume of legal-tender money—but to a certain extent they take place independently of such variations. The process is most easily illustrated by reference to the case of an increase in the cash balances of the ordinary banks, through Government borrowing on “Ways and Means.”

Taking the case of one bank, X, suppose it has received one million additional deposits and one million addition to its “cash at the Bank of England.” It could afford to subscribe for Treasury bills to the amount, say, of three-quarters of a million pounds. That money goes first to the Government’s account at the Bank of England and is soon paid out again and becomes further deposits in other banks. Simultaneously banks Y, Z, etc., have been doing the same thing, so that bank X finds its deposits increased again by nearly three-quarters of a million (there will be some increase in the amount of cash remaining out in circulation, so that not quite the whole of the money lent to the Government will

come back as deposits). X's "cash at the Bank of England" will be restored nearly to the amount at which it stood before the subscription to Treasury bills was made. On the strength of increased deposits, further loans to the Government can be made and the process can go on until the ratio of loans to cash has reached the limit which is considered safe. If that ratio is six to one, the ten millions of new money originally created by the Bank of England can be the means of enabling the other banks to lend something like 60 millions in addition, though not all at once, and in spite of the fact that no bank lends any money which it has not already received as a deposit.

As a matter of fact, however, the process was sometimes hastened by arrangement with the Bank of England, whereby the other banks were enabled to lend to their customers money for subscribing to war loans, in excess of the amount which the existing balances of those banks at the Bank of England would have enabled them safely to lend in the absence of any special arrangement. Thus it came about that the published Ways and Means Advances by the Bank of England did not represent the whole of the work done by the Bank in facilitating the creation of new money.

This illustrates how the banking system, given an increase of cash to the amount of $\text{£}x$, can multiply "money" to about six times x , this being the approximate ratio of liabilities to cash in hand and at the Bank of England which is regarded as reasonably safe, according to the bank balance sheets. When all banks add to their loans in about the same ratio, none of them find that their balances at the Bank of England—part of which they are theoretically lending—are in fact drawn upon. Their deposits are increased almost as much as the increase in loans.

The reverse process can take place. If banks see that prices threaten to fall, for instance, they become more cautious about lending, fearing that customers may fail to repay loans on maturity. If any one bank, let us say, contracts its loans to the extent of $\text{£}x$, it does so with the idea of *adding to its cash reserve*, and if it acted alone, that would result. But if all do the same thing, they all defeat each other's object to a large extent. The "cash" does not increase, but each finds its deposits falling off. That, it is true, improves the ratio of liabilities to cash, but simply to diminish liabilities by $\text{£}x$ is not so great an improvement as adding $\text{£}x$ to the cash,

which was the intention. Further, it means that each bank finds the rate at which money is flowing in has decreased, and that leads the bankers to say quite truthfully that they have not so much money to lend. Some of their customers have to realise stocks of goods in a hurry, prices fall still further and there is more caution on the part of the banks about lending, and a further shrinkage of deposits. Thus occur money crises.

Something of this kind appears to be happening now, although it is possible that there is not, so far, any actual contraction of the volume of money, but merely a slowing down or cessation of the rate of increase. It may turn out, when next December's balance sheets are published, that the totals of deposits, loans and cash are larger than in June last.

There has been much experience of these situations in the past, and the bankers in this country are not so precipitate and panicky as they used to be long ago. The question of the exact nature of causes of the present situation is of importance, as bearing on the outlook for the future, and will be recurred to again, but first of all it is necessary to say something further on the bearing of the floating debt upon the monetary situation, taking a long view.

Significance of the Floating Debt.

The continued existence of a large floating debt renders possible a recurrence of the process of inflation. During the period from March, 1919, to March or April, 1920, a renewal of inflation was produced by a considerable running off of Treasury bills, compelling the Government to make fresh borrowings on "Ways and Means" to meet their obligations, and so providing the banks with more cash at the Bank of England, and this can go on even though the total of Government debt is not being increased.

It is not suggested, however, that the holding of Treasury bills by the banks or the public is the same as if they held actual cash to that amount, or that the banks can class these bills under the heading of "cash in hand and at the Bank of England" in their returns.

Most of the banks give no explanation as to the heading under which Treasury bills are classed, but they can scarcely be actually classed as "cash." It may be of interest, however, to note that this is conjectured to be the case by an American writer, Mr. Harvey E. Fisk, who, in a volume published by the New York Bankers' Trust Co., entitled

“English Public Finance,” states (p. 47), “It is probable that some banks treat Treasury bills as equivalent to cash, while others treat them as investments or as discounted paper.”

The published balance sheets of many of our banks are well known to be enigmatical, especially in regard to the item “cash in hand and at the Bank of England,” and to represent the state of things on a particular day, arrangements having been made to have the “cash” increased for the occasion. There is no reason, however, for doubting that on the day in question each bank has cash in hand or at the Bank of England to the amount stated, and such cash is not, at the moment, lent to anyone and is not earning interest. It is the unused reserve. Money invested in Treasury bills could not be classed under this heading, even though they may be going to mature on the following day.

To any one banker, an investment in Treasury bills appears to be much the same as any other investment for the same length of time—six months or whatever it may be—which is of a perfectly safe character. The peculiar nature of Treasury bills is not in the mere fact that they are “safe.” Commercial bills discounted and many other

forms of loan are quite safe to be met at maturity.

Also, it must be remarked that for any one banker, a Treasury bill is the same as any other short loan in this respect, that on its maturity, he can, if he so desires, strengthen his cash position by letting the loan run off and not renewing it.

There are, however, two special features about Treasury bills which are of great importance from the public point of view, but especially the second.

(1) Short term loans to traders, though technically always liable to be cancelled at maturity, are often of a kind which it would be unwise not to renew, because the customer might be put to great hardship, and even ruined, and this especially in times of crisis. In the case of a loan to the Government, however, the banker knows that if he does not renew the loan, the Government can always fall back on the Bank of England. Hence whenever traders are keenly demanding advances, it is very natural for the banks to run off the Treasury bills and lend the money to traders. Traders, also, holding such bills on their own account, can let them run off whenever they want money.

(2) For any one bank desiring to improve

its cash position it may be apparently just the same whether it runs off Treasury bills or whether it runs off other loans which mature, but the important difference is that for the banking system as a whole, the running off of Treasury bills adds to the "cash" of the whole system, whereas the running off of a loan to a trader by any one bank strengthens the position of that bank mainly at the expense of other banks.

It is true that the "market" can go to the Bank of England for further accommodation, but that puts it in the power of the Bank to check the demand by raising its rate of discount. The Bank is under no contractual obligation to find new money and can make its terms so as to conserve its own position. There is nothing to compel the Bank to take any steps to add to the quantity of the fiduciary issue of currency notes merely because the market desires more money, and if this were the only kind of demand on the Bank, it could control the situation as it did under the gold standard.

By running off Treasury bills, however, the bank can compel the Government to go to the Bank of England which must make the required advance, knowing that the Government can and must supply extra currency

notes so far as will be required, to make good any deficiency of cash.

It is true, of course, that the rate of interest on Treasury bills is an effective factor in limiting this process. The banks and other holders will not run off Treasury bills unless a better rate is offered by other borrowers, and the Government can limit the process by offering a sufficiently high rate of interest. What is desirable is that they should not be forced to adopt this expensive measure of checking inflation. Once the cycle of rising prices gets started it may pay traders to offer very high rates of interest in order to make purchases before the rise of prices goes further. There is nothing in the present position to ensure that this process will not start again and compel a further increase of the rate for renewal of Treasury bills. Even if the rate is not forced up further, there seems to be no prospect of any diminution so long as a considerable floating debt lasts.

If the present high Bank-rate is maintained for a long time, it would probably imply a prolonged period of rather slack trade and considerable unemployment. That, in turn, would mean both diminished receipts from taxation, especially from the excess profits

tax, which has so far provided such large sums, and additional expenditure for the relief of unemployment. In these days no Government in this country can simply stand by and treat unemployment as something beyond its power to alleviate. The surplus of revenue over expenditure, therefore, could scarcely be made considerable and it is even probable that the Government may find it impossible to avoid creating further debt to a certain extent and the unsatisfactory situation might threaten to continue indefinitely, with alternations of violent inflation and depression.

Some attention may be given, therefore, to the question whether the floating debt cannot be dealt with by some more expeditious method.

Repayment of Floating Debt: (a) Funding Loan.

First of all we may consider the operation of funding loans, which could, of course, be raised from time to time, and used for the repayment of floating debt, even if the rate of interest had to be high.

The tax system may be assumed to be made to abstract from the public as much

as is considered practicable of their current income which would otherwise be spent on current enjoyment. A subscription to a funding loan must be expected, therefore, to come either from existing capital or from current savings. If I pay over to the Government one hundred pounds which otherwise might have been lent to the London County Council for building houses, and the Government pay that hundred pounds to my bank, the theory as stated by some writers is that the bank simply regards the hundred pounds as gone. If that really were the case, it is easily understood that the process carried out on a large scale, and taking up a large part of the nation's savings for several years, would mean severe depression in the constructional trades and a still further accentuation of the shortage of houses and works of construction.

In normal times, when credits have been granted too abundantly, and as they mature, the banks curtail credits, the curtailment does not have any prompt effect upon normal *bona fide* savings, and does not concentrate itself entirely on reduction of the supply of money to the industries which are kept going by savings (though it does affect them rather severely, indirectly, and produce in that way, depression in those trades). The application

of a great part of normal savings to the paying off of Treasury bills would be an operation different in kind from normal restrictions of excessive credit and it does seem doubtful whether it is desirable that it should be carried out in any drastic manner, and this doubt is not removed even if we recognise that the banks, in all probability, would probably be ready to lend out again a good deal of this money. Some of it, perhaps, they would use for the purchase on their own account, of permanent securities, and so, indirectly, it would again become available for investment in constructional industries. In the main, however, banks prefer to lend for short terms, and it is difficult to see how the supply of capital for constructional purposes could fail to be very seriously curtailed, whilst the supply of money for financing trading operations which are concerned with the production and distribution of current and quickly available wealth, with the aid of already existing buildings and plant, would be perhaps increased, and prices of such currently consumable wealth might even be raised by the operation.

Another alternative is, that subscriptions might be made by some process of pledging existing capital. If, instead of lending such

accumulated savings as I may have still uninvested, I obtain a loan from my bank of one hundred pounds on the security of stocks or shares, that is a creation of new credit, and it may seem anomalous that the repayment of Treasury bills, the ultimate aim of which is to stop inflation, should be effected by means of a new inflation. This anomaly is not the most substantial objection, however ! What it really means is, that the bank has a claim on me for one hundred pounds substituted for a claim on the Government.

Whatever might be the nominal term of such loans to individuals to enable them to supply the Government with funds to repay the Treasury bills, the banks would be bound to acknowledge that they could not in practice be called in on any extensive scale, but would have to lie until they were gradually paid off by savings out of income. These loans would not, therefore, be liquid assets in the same sense as Treasury bills which have behind them the Government with its control of the output of legal tender notes.

The economic results, however, do not seem to be very different from those of the preceding case. If carried out on a large scale so as to supply several hundred millions in a year, this method of paying off Treasury

bills would mean that the normal supply of money from savings was diverted from the constructional industries.

There is, perhaps, another alternative, namely, that the money intended for repayment of Treasury bills should be taken from funds which would not in any event have been used for the production of very durable capital, such as houses, water works, etc.

Very little is known about the magnitude of the volume of money which is capital kept and used in such ways that it could be made available, apart from the creation of additional credit by the banks. This class of money is mainly employed in businesses by the owners of it, and is not readily diverted to other uses in times of business activity. It is precisely the kind of capital which has been earning a high rate of profit as the result of rising prices. In the case of this class of money, capital and income are not so readily distinguishable, because in many cases the capital is frequently re-appearing as money, increased or diminished according as the transaction in which it has been engaged has been profitable or not.

It is doubtless desired by those in authority that a good deal of this liquid capital should be obtained. It is the liquid capital of dealers

of all kinds (especially stock and produce dealers), of men who underwrite new issues, of risk underwriters, and it merges into the circulating capital or working capital of all classes of industry, and to a substantial extent it is provided by the banks, but, of course, a very large amount in the aggregate has been accumulated out of savings in the past and is not owed to the banks.

The new loan carrying a rate of interest varying with the rate for Treasury bills is intended to attract liquid capital. The "City," however, which means more particularly the owners of the class of capital in question, does not seem particularly to welcome this loan, and no very substantial results are to be expected from it.

*Repayment of Floating Debt: (b) Capital Levy
or Forced Loan.*

The payment of a very heavy rate of interest on funding loans might be obviated by resort to a capital levy—either a levy pure and simple, or a compulsory loan carrying a low rate of interest. Proposals of this kind have been put forward usually, it is true, as a means of reducing the permanent debt, but as the floating debt amounts to about 1,200 millions,

it is fairly clear that most of the money obtained, and at all likely to be obtained within a few years, would be absorbed by repayment of the floating debt.

This proposal is evidently disliked very much by the spokesmen of the banking interests, and some objections of a different nature have already been mentioned above. The proposal cannot, however, be dismissed as necessarily impracticable, and must be entertained as one likely to be adopted, for better or for worse, at least, if no satisfactory alternative is found.

The economic objections to the capital levy do not appear, on examination, to be so insuperable as they are apt to be represented. A summary statement of what appears to represent the bankers' point of view is found in an article in the *Times* for June 1st, headed "Deflation: Menace of the Floating Debt." Towards the end of the article the writer refers to the proposals for some form of capital levy, and offers the following adverse criticism: "We admit the question of dealing with the floating debt is a peculiarly difficult one. But certain facts are quite clear as to what cannot be done. The process cannot be hurried. If resort be had to a measure to produce a large sum in a very short time,

certain businesses would be deprived of capital and would have to restrict their operations. That would mean less revenue to the Government and a restriction of trade, which would tend to prevent prices of commodities from falling. The Government is a partner in industry and trade ; the larger the amount of capital employed, and the greater the activity of trade, the larger will be the Government's revenue with which to reduce debt and bring down prices. Therefore, the surest way to facilitate effective deflation is to develop the commodity side of it, which can only be done by restoring confidence, and eschewing any form of taxation which stifles enterprise and limits production. Given these conditions it would be found easy to deal with the floating debt in the course of two or three years. But a definite programme for dealing with the debt is an absolute necessary condition of economic reconstruction."

How it would be found easy to deal with the floating debt in two or three years the writer does not disclose, but we are concerned rather with the objections to the plans which have been put forward based on a capital levy designed to bring in a large sum—not, as he suggests, in a "very short time," but within two or three years. No one has ever

been able to suggest that 1,200 millions available for repayment of floating debt can be obtained within three years by any ordinary taxation of income, and the contrast is between obtaining some such sum by means of a capital levy within two or three years, and spreading the period of repayment over a much longer period.*

The proposal, moreover, is not, as the writer above quoted implies, a method of "deflation" in so far as it involves merely the repayment of Treasury bills. As he points out in an earlier part of the same article, so long as the fiduciary issue of legal-tender Currency notes is not materially reduced, "the mere operation of repaying the floating debt would not, of itself, diminish the banks' power to create credit. . . . so long as the limit on the fiduciary note issue remained the same, the banks would be able to create credit for trade in proportion to the amount of floating debt redeemed."

The writer, probably, when referring to the capital levy, is thinking of something which

* It is to be recollected that a good deal of debt which is not counted in the £1,300 million of floating debt becomes repayable within a few years. Consequently large deductions have to be made from the proceeds of any funding loans, or from surplus revenue, before arriving at the amount likely to be available for repaying this £1,300 million. Hence a long period of time is necessary, in the absence of some special measure.

would provide more than enough to redeem the floating debt. That consideration, however, can be disregarded for the present, because, as already remarked, the floating debt must, in any event, swallow all that can be obtained from any levy within two or three years. Whether any additional sums should or could be obtained by such means for repaying more or less of the permanent debt, and whether, if that were done, "deflation" would result, is quite a different question.

If we assume for the present, that a capital levy of £1,200 millions is to be raised to repay the floating debt, within, say, three years, the working of the project requires to be considered from several points of view.

In order to be of use for the purpose intended, the levy must be paid in money or Treasury bills. The surrender of stocks and shares, even of Government funded loans, would be of no use, and the discussion must therefore be on the basis of payment of the levy in money:

There is, on the one hand, the distinction between the repayment of the Treasury bills held by the banks, the repayment of Ways and Means advances, and the repayment of those Treasury bills held by other persons or institutions. On the other hand, there

is the distinction between the class of payers of the levy who hold a sufficiency either of Treasury bills, War loans, or readily realisable securities, and the class of persons liable to the levy whose capital is not in any readily realisable form.

As regards repayment of Ways and Means advances from the Bank of England, it may be noted that if money is paid to the Government by taxpayer A, by means of a cheque on his bank X, and is used for repaying Ways and Means advances, this bank's balance at the Bank of England is diminished by the amount in question, and there is no replenishment. This bank's capacity for giving credit is thereby diminished, and the Bank of England's capacity for extending credit is not increased by the extent to which X's credit is diminished, because the Bank of England is supposed to be more conservative than other banks in regard to the ratio of its cash in hand to its liabilities. That conservativeness has, it is true, been very much modified by the War, but presumably the Bank of England will tend to revert, as opportunity offers, towards pre-War ideas as to the ratio of cash in hand to liabilities, and when the Government repays Ways and Means advances, the Bank will not consider that, *ceteris paribus*, it

has that money to lend out again to other people as a matter of course.

In the case of repayment of Treasury bills to non-banking holders, when these holders received the money in repayment, they would have it available for investment or for lending elsewhere. To that extent, there would be a fund available to purchase securities from those payers of the levy who had saleable securities to dispose of, and as between these payers of the levy and these receivers of the money repaid, the banks would only be required to act temporarily as intermediaries. They could advance temporary credit to those who had realisable securities, to enable them to pay their levy, and as soon as the holders of the bills were paid off, they would be in the market to buy securities, and those payers of the levy who had had credit advanced to them would be able to sell securities and repay the banks. This operation need give rise to no serious monetary difficulties or heavy fall of prices of securities. There would probably be some fall in the price of securities, however. The paid-off holders of Treasury bills would, presumably, prefer lending for short periods, and would be unwilling to lock up their money in securities. There

would be a surplus of "short" money available, but the interest obtainable on it would fall, and drive people to buy securities instead.

The cash balances of the ordinary banks with the Bank of England would not, as a whole, be affected by this operation, as the persons holding Treasury bills, which were paid off, would normally have their accounts with ordinary banks, and when the Government paid off their bills, this would restore the balances at the Bank of England to their previous level.

To some extent, no doubt, payers of the levy would be able to pay their quotas from their existing balances of unused money lying to their credit at their banks. In so far as payment was made in that way, the effect on the balance sheet of a bank which received, in repayment of Treasury bills, approximately as much as had been paid, in this way, by its customers, would be simply a diminution on the liabilities' side of £x due to depositors, and on the assets' side a diminution of £x due from the Government. The bank's potential capacity for further inflation would be reduced, but in so far as the amount of its loans and advances was limited to a certain ratio between cash in hand and at the Bank of England, to loans and advances,

that ratio would be improved and £x of credit could be re-created.

The next case is that of payers of the levy who had no readily realisable securities and who could not pay from existing balances. They would require to be accommodated by their bankers for a long period of time.

The banks themselves, further, would also be in the position of receivers of money repaid to them by the Government, and, as pointed out by the writer of the article above quoted, they should be in a position to relend this money, and they could lend it to the business men who were unable to realise securities in order to obtain their quota of the levy.

The position of the banks would simply be that on their assets side, instead of £x millions due from the Government, they have £x millions due from private persons and firms.

The ordinary banks' balance at the Bank of England, it should be noted, would not be altered. If I borrow from my bank, X, £100 on the security of stocks or War Loans and pay that to the Government, who put it to their account at the Bank of England, my bank, X, loses, *pro tem.*, £100 of its balance at the Bank of England, but immediately afterwards the Government pays bank X

£100 from the Government's account at the Bank of England, and X's balance is therefore unaltered. It might happen, however, in the case of a small bank that its customers' total liability for levy which had to be obtained by way of loan from the bank, was substantially more than that bank's holding of Treasury bills, and such a bank might find some difficulty. It ought not to be impossible, however, for any bank in sound condition to make arrangements either with other banks or with the Bank of England. Taken as a whole, the balances of the banks at the Bank of England would be unaltered. The real change would be £x millions due from private persons instead of from the Government.

Bankers' Objection to Capital Levy.

In opposing the capital levy, the representatives of the Bankers' Institute, before the Select Committee, appear to have contemplated an attempt to obtain the payment of hundreds of millions all at once. That, of course, would be impossible. The balances of the joint stock banks with the Bank of England would be wiped out before the repayment could be made. What is con-

templated in this pamphlet is the payment of levy to the Government at the rate of about one million pounds per day for three years. After the first few days the return payment to the Banks, or to customers of the banks, would balance the amount drawn to the favour of the Government account at the Bank of England, and it is not apparent why any acute financial crisis should arise.

In regard to the risk to particular private businesses, of which much was made, it has to be recollected that the proposal under discussion by the Committee related only to a levy on persons of substantial wealth whose wealth had largely increased since 1914. It is not very easy to believe that the necessity for liquidating a fraction of that wealth—at a time when free money for re-investment was being set free simultaneously—would put them in a hopeless position. Most of such firms are engaged in merchanting of some kind or other, either stocks or commodities. It would mean that they might have to curtail these operations, but these are kinds of business such that if one firm does less of the business, another does more. The man who has extended his operations five-fold since 1914 might have to be content with an extension to the amount of three- or four-fold only.

The limited scheme for taxing War-time increase of wealth, which has recently been rejected by the Government, was certainly open to the objection that it would provide very little free money available for redemption of floating debt ; since it was contemplated that the payment might be made, and would largely be made, in the form of surrender of funded War Loan stock. The Government appear to have accepted rather easily the bankers' objections to requiring people to find cash. For the reasons set out above, it is rather a superficial view that if the banks had to advance loans to the payers of the levy to enable them to pay their quotas in cash that would mean further inflation, and it is also a superficial view to make a mistake in the opposite direction and ignore, as is so constantly done, the fact that if payment is thus made in money, there is, to an appreciable extent, a fund made available for the purchase of securities, by those who receive the payment of their Treasury bills. The bankers might reasonably be asked to go into more detail as to the disastrous effects which they anticipate, to show just what would be the effect on their position of the *whole* process—paying the tax by some and having the money received by others—including, in the latter case, the banks themselves.

It may be conjectured that the bankers' alarm at the prospect of having to advance credit to those who have to pay the levy is due partly to a failure to discriminate between an advance of credit for such a purpose and an advance for ordinary purposes. If a bank has two customers, A and B, both solvent and substantial people, and if B owes £1,000 to the bank and A owes £1,000 to B, the bank can advance the £1,000 to A in order to enable him to pay B, who will then repay the bank, and there is no inflation of total credit involved. It is not as if A simply wants an advance which would not lead to any corresponding repayment to the bank within a reasonable time. That is analogous to the case in question, B standing for the Government and A for the persons who have to pay the levy.

This operation means that the floating debt is, in a large measure, only transformed into another kind of floating debt, and is really paid off only out of income, over some more or less lengthy period of time.

By hypothesis, however, the payers of the levy are persons of substance, and should be able to furnish sufficiently good security to their bankers. If need be, the levy could be a compulsory loan, instead of a pure levy.

In that case a man having to find £1,000 would receive securities from the Government, worth, perhaps, £600, and to that extent his ability to furnish security to his banker would be increased. From the point of view of dealing with the floating debt, at least, it would be better for the Government to receive £1,000 millions and give new securities worth £600 millions, than to receive only £400 millions as a pure levy. If, therefore, the giving of some security carrying less than the market rate of interest enables a substantially larger sum to be raised than would otherwise be considered possible, such a scheme might well be considered.

It is not obvious, however, why there should be any very fundamental difference between a pure levy and a forced loan, seeing that, as already remarked, those liable to pay would be people who could, in any event, furnish security. The point which has to be kept in mind in considering whether there would be any risk produced of insecurity of the banking system, is that there are two entirely different questions involved. An individual bank may get into difficulties by action which is imprudent, solely because it is peculiar to that bank. If a bank invests, for instance, too much money in lock-up

securities—lending to house-builders, for instance—that endangers the particular bank, because the receivers of the loans pay out cheques payable to customers of other banks. If, however, all banks did the same thing at the same time this particular danger would not arise. The whole question of the proportions between liquid and non-liquid assets is of this class, and it is entirely fallacious for a banker to look upon the question of the effect of the compulsory levy as if the alteration which would be produced in his balance sheet were peculiar to his bank. There would be nothing to cause extra large payments on balance from one bank to another so as to endanger the safety of any one bank.

So far as the whole banking system is concerned, danger only occurs from difficulty in finding enough legal tender currency. Now there is nothing in the proposals to cause any extra demand for currency by the public. There is no inflation produced. On the contrary, to a limited extent, there would be deflation.

For the banks the resulting position would be unfavourable in the sense that they would have an increased volume of outstanding loans of a kind which could not be readily called in, and this is a situation which, if

it had arisen through normal operations of any one bank might cause alarm. It is submitted, however, that the normal maxims of prudence, which have been based upon the experience of individual banks acting in a purely individual manner, are not necessarily applicable to a situation in which, by arrangement with the Government and the Bank of England, the banks act in unison.

It is almost inevitable that those who have been brought up in the practice of banking take the point of view of the individual bank acting on its own responsibility and having no definite knowledge of what other banks are doing. From this point of view as has been stated earlier money is something indestructible; the bank receives deposits and can lend out a certain proportion of them for long periods, a certain proportion for various shorter periods, and must keep in hand a balance of cash, in its vaults or at the Bank of England, earning nothing. The daily business consists mainly in watching the prospective flow-in and flow-out of money to and from that bank. The flow-in is kept, on an average, equal to the flow-out by the mere fact that all banks and their customers are doing much the same kind of thing. The fact that loans are for short periods only,

however, is an additional safeguard to ensure that the money of any one bank will not run out largely in excess of what is coming in. There are liable to be, at certain times, exceptionally heavy calls for loans from customers who would be very seriously prejudiced if they could not be accommodated. Those loans must be taken to involve almost certainly a liability for this bank to meet heavy calls at the clearing house, and in order that its cash balance may not be unduly depleted, it is convenient to have falling due at that time other loans which can be relied upon to be paid on maturity. Nothing can be better than to hold Treasury bills falling due at the time in question. If, instead of Treasury bills the bank has loans due from private customers who have had to be financed by this bank, the customers may be unable to repay at the due date. Hence this bank would not feel able to meet the expected demand for loans, and there might be an acute stringency.

If we look at the banks as a whole, however, is it the case that the normal requirements of business would require them and other holders of Treasury bills, taken together, to run them off? Suppose the Government, instead of paying off these bills as proposed, kept

the rate of interest always at such a point that the volume of bills subscribed for always equalled the volume maturing. There would then be no running off. Would this situation be materially different from the point of view of the safety of individual banks, from that arising from repayment of the bills through a compulsory levy? Would it be materially different from the situation which would be produced by a repayment of floating debt, within just the same period of time, by means of heavy taxation and funding loans? Any of these alternatives involve a certain degree of stringency as compared with the past periods in which Treasury bills were really being run off faster than new bills were subscribed for. The check to that process resulting from the increase in the rate of interest has brought on the inevitable day of stringency already, and prices are having to be adjusted to the volume of credit rendered possible by the existing issued legal-tender money instead of being based upon a continuous increase of it. Once that adjustment is effected it is not apparent why any very serious further stringency should be caused by any process of preventing the floating debt from being used to add to the already large basis of legal-tender money.

If the banks and the money market generally are, as a whole, to be prevented from actually running off Treasury bills and compelling the Government to borrow further on "Ways and Means," the problem for the individual bank should not be insoluble. If any one bank required to run off such bills, there must be others who will have funds to spare, and as banks can borrow from one another, the credit operations of any one bank would not be rendered unduly rigid.

Capital Levy : Alleviation of Stringency.

Further, under a *régime* of paper money, the Government always has the means of coming to the rescue if nervous fear of the unknown consequences of a new departure in finance led, as it possibly might, to a panicky feeling. The Government might quite well undertake that if its compulsory levy operations did produce unforeseen results, and led to any serious danger to banks and financial houses which had honestly acted in accordance with the programme, and, in their ordinary business had only granted the credits required for normal business, the Government, through the Bank of England, would be prepared to see that temporary difficulties were tided over.

Although the ultimate object of the whole proceeding would be to put an end to further inflation, it would not be necessary for the Government to tie its hands by any hard and fast rule regarding the extent of the fiduciary issue, and if the operation itself led, for a time, to excessive stringency, this could always be remedied if there were need. It would only be necessary to see that if, to prevent a crisis, further issues were made, they should not be allowed, after the crisis was over, to be made the basis of a new inflation movement. With the floating debt largely funded, this should not be a task of insuperable difficulty, even if, during the process, steps had been taken which, if they had been taken by themselves, and independently of the funding operation, would have tended to produce inflation.

It is necessary to be on guard against the mistake of supposing that both catastrophic stringency and inflation can be occurring simultaneously. "Deflation" is often mentioned as involving severe stringency, and it is assumed that any steps to limit that stringency must be illogical, and inconsistent with the object in view, because they would be of an inflationary type. The truth is that they would merely render possible some

future inflation, which, however, could be prevented from occurring.

Capital Levy: Proposed Restriction to War Wealth.

The objection on grounds of equity to the particular proposal which has been rejected by the Government, namely, that it is not confined to persons who have made abnormal profits out of Government contracts, but covers all increases of wealth beyond certain proportions, does not appear to be very strong. During a period of monetary inflation many people have the opportunity, without their specially seeking it, of making abnormally large gains, far in excess of what might be regarded as a mere increase in the nominal value of wealth due to the depreciation of money. There is not necessarily anything blameworthy about the methods by which such gains are obtained, nor are they specially connected with Government contracts, and the case for a special levy upon such abnormal gains should not be made to rest upon any supposed wickedness of the recipients, but simply upon the fact that they have been in a position to come in for windfalls as a matter very largely of luck. They are an unintended

by-product of the method by which the War was financed. Some of the recipients might have made equally large or larger gains if there had been no War and no money inflation, but it cannot be doubted that the monetary inflation was very largely responsible for a great part of the abnormally large gains made during the five years in question. The equity of the case has really nothing to do with the fact that men were being killed. It has to do with the fact that money was being manufactured in unprecedented quantity, and its distribution subjected to an altogether abnormal disturbance, affording undeserved losses and undeserved gains to those who happened to be placed in certain situations.

This limited form of levy would have one advantage over a more general levy, apart from the practical question of assessment, in that it would be less dangerous as a precedent which might be crudely imitated all over the world. The danger of crude and ill-considered imitation is one which should be borne in mind. It may be quite true that the purpose of a levy made in this country at the present time would be one which afforded considerable justification for this expedient. As previously contended, the

general economic objection to raising revenue from capital would not apply. There are many countries, however, in which the same method of raising revenue for quite other purposes would be likely to commend itself if once the way were shown how to do it, and that probability of crude imitation is, perhaps, at the back of the minds of financial leaders. This objection does not seem very strong, however, in the case of the proposed levy on increase of wealth during the War.

Although some considerable disturbance and probably some anxiety and temporary irregularity of prices of stocks might be looked for, seriously affecting the man who is interested in short period price movements, one must conclude that a capital levy for redemption of the floating debt, or to assist towards redemption, should not be ruled out of account, as involving any grave economic disaster, at least on the merely vague and inconsistent alarmist statement of opinion which so far have been relied upon by critics of this policy. One of the Bankers' representatives before the Select Committee (question 1841, P. 1119) took a line entirely at variance with the report of the Cunliffe Committee as to the cause of high prices. Both witnesses

stated that "as the result of the imposition of this tax we shall be in serious danger of a financial panic such as this generation has not known" (1853) and the panic would throw an enormous number of people out of work (1854). Nevertheless, these same witnesses were quite sure, immediately after making this statement, that the process, if once adopted, would be repeated in the future, in spite of the disastrous consequences of one trial. It is further to be noted that the Bankers' representatives promised to see if they could not find any alternative method of dealing with the floating debt. No alternative was put forward, however, on the excuse that any proposal based on taxation of income would not fall within the terms of reference of the Committee. That may excuse the bankers from making proposals to that Committee, but is it not "up to them," if one may use a convenient vulgarism, to tackle the question in one way or another instead of evading the responsibility which their position of influence places upon them? The economists' proposals may be wrong—quite likely—but is it not for the bankers to show clearly both how and where, and to show what better solution can be found? The main objections clearly foreseeable are:

First, the difficulty of assessment, which is greater the wider the field covered ; second, the fact, previously mentioned, that the flow of normal savings towards permanent capital investment might be diverted to an undue extent and turned into bank money not readily available for long lock-up investments, though available for other processes of industry.

The Alternative to a Capital Levy—Control of Fluctuations : (a) During Expansion.

If special measures for funding or paying off the floating debt are ruled out, the prospect is, as already remarked, that it will remain for a very long time, and will be a constant source of danger of renewed inflation. In some ways, no doubt the easiest course, would be to take no special measures and to allow inflation to continue from time to time. That would tend to depreciate the value of money still further, to increase the money incomes of the people and the yield of taxation, and so to lighten the burden of the national debt.

This means, however, continual adjustment of wages and salaries, with inevitable friction, a further harsh treatment of those living on

fixed incomes, every now and then a pull-up such as is now being experienced, with consequent dislocation of industry. Most serious of all, however, is the inevitable instability of foreign exchange, introducing a great gambling element into all foreign trade; and foreign trade is so important that its fluctuation reacts upon a large part of the industry of the country. Merchants abroad, especially in the East, tend to rush orders for goods recklessly when the exchange is tending to favour buyers and to cancel orders and put off payment for goods already received when the exchange is going the other way. This puts a great strain on the credit system and adds to the causes producing employment fluctuations.

It ought to be possible for the banking community, in conjunction with the Treasury and the Bank of England, to control at least the domestic currency situation so as to avoid a recurrence of inflations and checks, even though the floating debt is repaid only slowly over a long period of time, by means of the surplus of revenue over expenditure, and funding loans of moderate amount.

That appears to be the smoothest way of dealing with it, and is to be recommended, provided that the necessary steps are taken

to avoid inflation and its concomitant periods of reversal.

When practically all the important countries of the world had an effective gold standard it was not so necessary to regulate the currency position in this country with a view to maintaining stability of prices, and it would have been more difficult to do so. Our banking system was only a part of the world system and the monetary fluctuations were largely of a world-wide nature, beyond the control of any one country. Now, however, the situation is different. Whatever may be the inconvenience of the *régime* of national paper monies, they have this peculiarity that, so long as they last the domestic money situation of any one country is capable of being controlled to a degree which was not possible before the war. The possibilities of deliberate control require to be explored much more fully than they have been hitherto.

If we regard once more what happened in the inflation period from March, 1919, to April, 1920, it is obvious that the inflation proceeded by nobody's deliberate choice or intention. The Chancellor of the Exchequer, advised, no doubt, by the best experts, apparently thought, early in 1919, that prices would be coming down and that the Excess

Profits Tax must be cut down for fear that industry might be restrained unduly. This turned out to be a wrong forecast. This year he re-imposed and increased the tax, and not very long afterwards the inflation process came to a halt and many bankruptcies are threatened. Now it is certain that both movements were at least very largely the outcome of the working of our own money system.

Bankers, merchants, manufacturers, wage-earners, during the inflation period, all felt that they were doing only what appeared to each to be the obvious business necessity. The customers of the banks required more credits, because goods cost more, and there was no apparent reason why they should not have it, and on terms which left business highly profitable. Owners of businesses got more income and were ready to spend it. Employees of all classes naturally asked for, and were usually able to obtain, their share, and so the volume of money flowing into the retail markets justified the expectations of those who had anticipated a strong demand.

Once this cycle is in operation, it is as useless to ask, with regard to its continuance, whether bank credits, profit making by

dealers or manufacturers, or increasing wages and incomes of employees, are "the cause" of the movement, just as it is useless to dispute whether hens or eggs are "the cause" of the progression of hens and eggs. Workmen, in demanding higher wages, no doubt, frequently are only trying to catch up with a rise of prices which has already occurred, and to get a share of excess profits which are already being made. In other cases, however, workmen, just as much as anyone else, are liable to take the initiative, and by obtaining higher wages, produce a further rise of prices. The reason why it often seems to other people that their demands are in some special sense an independent cause of rising prices, and one which might, by voluntary restraint, be kept in check, is because workmen largely act in combination, and wages are settled, not by pure competition, but largely by agreements, arrived at at definite times and relating to large numbers at one time. If workmen had no trade unions and employers also acted quite independently of one another, there can be little doubt that many classes, especially of skilled men, would find in times like the last twelve months, that their wages ran up, perhaps further than they actually have done, by

mere competition for their services, and their consciences would acquit them of any deliberate selfishness just as readily as those of bankers, merchants, manufacturers and shopkeepers who found excess profits thrust into their almost reluctant hands.

The truth is that the banks, like everyone else, were in the rut of a movement in which everyone was apparently at each moment securing some advantage by getting more money, and at the same time everyone's action rendered the result nugatory by diminishing the real value of money in proportion to the increase of its quantity. To any one bank at any moment it seemed advantageous to act exactly in the ordinary way, and to get more income so far as it could be done, having regard to the normal precautions. There was, however, in the peculiar circumstances of the time, precisely the same futility about this for the banks as there was for miners or bricklayers.

The banking community were, however, in a special position of responsibility, and might have taken steps to mitigate the pace of the inflation movement. Individually no one bank could very well do anything to stop the movement, but collectively they could have done much if they had been prepared to act

in concert in limiting the creation of new credits at an earlier date. No other class could have done so. If workmen had refrained from asking for the rates of wages which the market conditions appeared to render possible, that would only have added to the profits of their employers. The root cause of the inflation was that the banks simply acted on their ordinary individualistic lines, lending as much as they felt to be safe, at the best interest obtainable. It is not fair to blame them for so doing, but it is surely incorrect to suggest—as, for instance, in the *Economist* review of the bank balance sheet figures (October 23rd, 1920)—that the banks, ever since the War ended, have been struggling with difficulty to supply the business world with enough credits to enable industry to get going. They supplied enough to enable goods to be held for speculation and values to be inflated to a very serious degree. If it be objected that holding for speculation was largely by people who were not dependent on the banks for loans, it must be replied that at least the bank credits, by financing manufacturers and some of the dealers, rendered possible the success of the independent speculators, by providing them with a market supplied with sufficient money to

pay the increasing prices which they demanded. It enabled manufacturers to bid against each other and run up prices in a way which afforded commercial justification for the speculators, and this money then came round into the retail market and supported the retail prices. The question must be asked whether some improvement cannot be made on this purely individualistic method in view of the dangers inherent in it under a *régime* of paper money.

No one can be expected to produce in advance out of his head a completely worked-out explanation of what action should be taken in all the contingencies likely to arise. There are innumerable questions of practical policy which can only be dealt with as experience is gained. *Solvuntur ambulando*. All that can be attempted is a sketch of general principles, with a view to helping forward the thinking out of a policy. The banking leaders themselves, it is urged, must recognise the responsibilities of leadership which their position entails, and cease to be content with an attitude of merely negative criticism and of putting the blame vaguely on the Government.

The broad principle which requires to be accepted and acted upon by the banks is

that if circumstances place in their hands the power to add to the volume of credit, beyond what is required for carrying on trade without advance of prices, they should refuse to allow the expansion, but should, instead, lend any excess funds to the Government for renewal of Treasury bills. In so far as they themselves hold Treasury bills, they should renew them if they possibly can on maturity. If the non-banking holders of bills fail to renew, and the Government is forced to go to the Bank of England for further overdraft advances, that will presently add to the cash balances of the other banks and place in their hands the power to expand credits. Instead of doing this, however, they can lend to Government, so as to enable the overdraft advances to be paid off.

Control of Fluctuations : (b) During Stringency.

It is impossible to lay down any hard and fast rule, however, and especially is it desirable that the possibilities of renewed inflation should not be allowed to become too much an obsession. At the present time, for instance, the monetary cycle seems to be running in the reverse direction. When that is the case, and the banks act in an

individualistic way, they tend to overdo stringency, not intentionally, but as the result of the action of each on the position of the others. Perfectly normal business, which would keep people employed, is stopped because of the apparent difficulties of finance. At such times the effect of joint consideration and joint action should be in the direction of relieving the stringency—at all events, once it is apparent that speculation for increased prices of commodities has been stopped. There is nothing gained by forcing realisation of commodities at prices below the level which can be expected to rule in the long run and precipitating bankruptcies and unemployment.

Of course, if it is deliberately intended to force down the current rate of money wages and incomes, and not merely to stop the increase, prices must first be forced down to a point which makes it impossible for the employer to pay current rates of wages. As a matter of fact, however, if any such result is produced it will not be the result of any deliberate policy of anyone, but an unforeseen and unintended result of the working out of individualistic banking, precisely as was the inflation of 1919 and 1920.

On the assumption that what is desired is

simply stability, what is required at the moment is that the Government and the banks should forget the fear of inflation and find the money to get on with all necessary work of production to the extent that can be carried out without sending prices up by inducing excessive competition for limited supplies of materials. If serious unemployment really threatens, the Government can quite safely, if necessary, obtain additional "inflation" advances from the Bank of England, and ignore the limitation of the fiduciary issue, *provided that the proposed understanding is arrived at with the banks, that when, as might soon happen, the opportunity for an inflation boom presented itself, they would not all follow their noses as in 1919-20, but would lend back any excess of credit for the purpose of repaying advances.* If there was still an excess of credit available, the Government should then borrow it and buy up currency notes already issued, until the danger of a new inflation had passed.

Any temporary action tending towards the possibility of further inflation requires to be taken with great caution however. It may well be the case that the present stringency will prove to be nothing more than the inevitable slight dislocation which

must attend the mere stoppage of the inflation movement. It is not suggested that every slight check to industry should be the signal for special measures.

The question of credits to enable Europe to resume trade has also to be looked at in a similar light. A present stretching of credit, even at the risk of present increase in the liabilities of the Bank of England and possible increase of currency notes, may not mean present inflation, but only risk of future inflation which could be avoided before it actually matured. (*See Note at end.*)

Rate of Interest as a Means of Control.

It may be that the necessary checking of inflation whenever it threatened could be achieved simply by a sufficiently timely raising of the Bank rate and the rate paid for new Treasury bills. Possibly this might be found to be the case, but, as already remarked, that might prove very expensive for the Government. Could not the banks agree to renew their own holdings of bills at a fixed rate, say, five per cent., and to supply surplus funds for further subscriptions at the same rate? All kinds of other businesses have had to submit to limitation of prices,

and if the banks were prepared to enter into some such arrangement it would have the effect of encouraging wage-earners to agree not to press, at every opportunity, for further advances in wages, even though employment be good.

It is true that the bankers have not made excessive real profits out of the war finance, but their inability to increase their dividends substantially has been largely due to depreciation of the value of securities which they hold, which, in turn, has been mainly due to the advancing level of prices, which brings about high interest rates and a correspondingly low capital valuation of fixed interest-bearing securities. The stoppage of inflation should be to their interest from that point of view and, of course, money which they did pay out to their shareholders would purchase more than it would do if inflation were allowed to take place. They could afford to give a lead to other sections of the community in the matter of the rate of interest charged for loans to the Government when that rate was made high for the purpose of checking that inflation which the bankers profess to desire to see ended.

There is a further question, however, which requires exploration ; namely, whether merely

adjusting the rate of interest is a sufficiently satisfactory method of regulating currency. Pre-war experience, under the gold standard, showed that although in countries with well-developed and experienced banking systems, and a central bank, very violent fluctuations and panics could be avoided, there was, nevertheless, an almost regular recurrence of periods of trade activity and stagnation. Whilst admitting, therefore, that if the state of comparatively mild fluctuations of pre-War times were restored, that would be an improvement on recent experience, we cannot rest satisfied with that as the last word in efficient management of the money system. If the system of individual enterprise and private ownership and control of the greater part of capital is to continue, some remedy must be found for the anomalies of periodical states of widespread and long-continuing unemployment, when hundreds of thousands lack both the necessities and amenities of life, and the means of production are in existence and only partially in use. If such a period sets in now, there will be vague talk of the inevitable reaction from the waste and loss of the War period, but the fact will be that men are not unemployed for lack of either food, raw

materials, or machinery and factories. Whatever evidence there may be of cosmical fluctuations in agricultural productivity as influencing fluctuations in trade, it can hardly be disputed that the working of the domestic monetary system has a great deal to do with such fluctuations, and we cannot rest content until this system, which is of human origin and should be controllable, has become more thoroughly understood and prevented from adding quite anomalous hardships to those which may be inflicted by nature, or by other circumstances in the outside world beyond our control.

It may turn out to be the case, as appears to be suggested, for instance, by Irving Fisher ("Purchasing Power of Money") and by Hawtrey's analysis (*cf.*, "Currency and Credit," Chapter III), that the trouble is due to the fact that bank rate is not advanced soon enough when inflation is beginning and its reduction is too long delayed when the turn in the cycle has begun. If so, the explanation of that has to be sought, and it will probably be found that unrestrained individualistic competition in the banking world is the cause, and that without some kind of concerted action, based on more accurate information as to what is going on in

the system as a whole, the delaying of the movement of Bank rate cannot be prevented.

Theoretical Basis of Need for Control.

It is not possible, in this pamphlet, to discuss at length the causes of trade fluctuations. There are, no doubt, other factors besides currency and banking, and with the best management of the money side of the question, there will still be irregularities. There can be little doubt, however, that to a very considerable extent the more widespread fluctuations are connected with the cyclical tendency inherent in the system of credit, which it ought to be possible to bring under control without interfering to more than a limited extent with the independence and enterprise of individual banks. Leading bankers do, in fact, recognise an obligation to take a wider outlook than used to be taken in earlier times, but it hardly seems that that recognition goes far enough, or that it is based on any really clear understanding of the way in which the whole economic system works. There should be some body created representing jointly the banks and the government, with power to obtain, in confidence,

the necessary data for studying the monetary system thoroughly, so that we may cease to have such contradictory accounts of the genesis of inflation movements, and of their converse. In the banking system there is found a particularly important instance of a partial failure of individual self-interest to lead to action tending to promote the general interest, arising out of the fact that in important respects the action of each bank is liable to affect the intentions of the others. Thus one reads that the banks could meet their business customers' present demand for additional loans if they could sell some of their securities without heavy loss. Now that is probably a generalisation from what one bank could do if it acted alone. One bank, by selling securities to customers of other banks, can strengthen its cash reserves. All banks simultaneously cannot do that. They can only diminish their liabilities to depositors, by an amount of £x, which is a much smaller change than an addition of £x to cash. One bank can, at any moment, strengthen its cash reserves by not renewing all its loans as they fall due, and *that is the assumption on which it works*, but, as previously pointed out, when they all want to do the same thing they defeat each other's

intention. In the reverse cycle there is a corresponding magnification of the expected results, instead of a diminution.

These conditions are a particular instance, but an unusually important instance, of a large class of cases in which the theoretical doctrine of "maximum satisfaction" fails under conditions of unrestricted commercial competition. In the case of credit, however, the tendency is at one time in the direction of causing too much to be offered, and at another time in the opposite direction.

To a certain extent leading spokesmen of the bankers do recognise that the working of the whole system has to be considered as something not quite the same as a simple generalisation from the case of any one bank. Experience of acute crises in former times has compelled this recognition with reference to such occasions. It requires further to be recognised, however, that this truth has application normally, and apart from occasions of acute crisis, and it has to become as clearly apprehended and embedded in the mind of every banker, not only of a few leading men, as firmly as are the maxims of individual banking salvation.

It is necessary to add, however, that if the aim of steadiness of employment is to be

achieved, or at least approximated to, the co-operation of other classes is also necessary. Either continuity of employment, or steadiness of prices, or both, will be sacrificed if workmen regard every period of steady demand for labour and absence of unemployment as necessarily an opportunity for enforcing, by concerted action, an increase of wage under conditions such that it can be granted only by raising prices. The Government and the banking community may be asked to take the lead, but others must be prepared to co-operate if the aim is to be achieved.

Prospect of Return to Gold Standard.

With regard to the question of a return to the gold standard little has been said. The reason is that this does not appear to be possible for a long time. It could be attained at an earlier date if the Government were determined to pursue a policy of definite deflation, involving the reduction of money wages and incomes. That would mean a period of severe unemployment, and it would also mean an increase in the real burden of the national debt. It would be extremely difficult to achieve in practice, because of the diminution of revenue which would be

involved—both temporarily during the inevitable industrial depression, and permanently, as the result of the increase in the purchasing power of money. Politically such a policy would probably be found impossible.

The outlook appears to be, therefore, towards a long period of inconvertible paper money. After a few years it will be seen whether, with the existing level of money, wages and incomes, there is any prospect of attaining a gold standard on the old basis. It may be found that we are gradually getting nearer to it, partly through the growth in the output of wealth and partly through a continuous increase of the level of prices in the gold-standard countries to which the flow of new gold from the mines will mainly go.

If it should appear, however, that there is no early prospect of the pound exchanging for 4·87 dollars, the question will then have to be considered whether it is better to carry on for a long period with inconvertible paper, or to make the pound note exchangeable for a less amount of gold than the pre-War pound, or to take more drastic steps to reduce the money income of this country. It is conjectured that the period of inconvertibility will probably be prolonged, that a large

floating debt will be in existence, and that long before it is cleared off most of the funded debt will be renewable.

When taking a view of the situation over a period of years, the renewability of the funded loans is almost as important as, if not more important than, the existence of the short-term floating debt as affording possibility of further inflation.

The possibility of a return to the gold standard at the pre-War rate of exchange has to be considered also, not only in the light of the existing inflation of money in this country, and its possible increase, but also, over periods of no great length, in the light of our indebtedness to the United States. Debts owing to us from impoverished Europe will be of little assistance as an offset, and it may be conjectured that the American Government in future will be in no mood to go out of its way to make things easy, as it has done in the past, by agreeing to postpone payment of interest.

In view of all these circumstances it appears that the return to the gold standard, which was declared to be our policy (at the Brussels Conference), is a long way off, and a mere declaration of that kind goes very little way towards solving the problems of the next

ten years or more. It has been the problem of this long transition period which has been under consideration in this pamphlet as being the matter of pressing interest.

*Note on the Question of British Government
Credits for Europe.*

It is assumed that such credits are proposed to be given at a time of trade depression in this country, and that they involve the creation of new credit by the Bank of England in favour of the British Government, thereby increasing the amount of "Ways and Means Advances." If £25,000,000 were so created in a year, there would be to that extent an immediate check to deflation. It is assumed that nothing is obtained from Europe in return for this credit within that time.

In the circumstances of depression, however, this check only means for the moment that prices do not fall as low as they otherwise would have done. If, in a number of important cases they have already fallen to the point at which production cannot be carried on, there is social advantage in stopping the fall, unless it is intended to render production possible on a lower basis of prices by reducing money wages. That, it

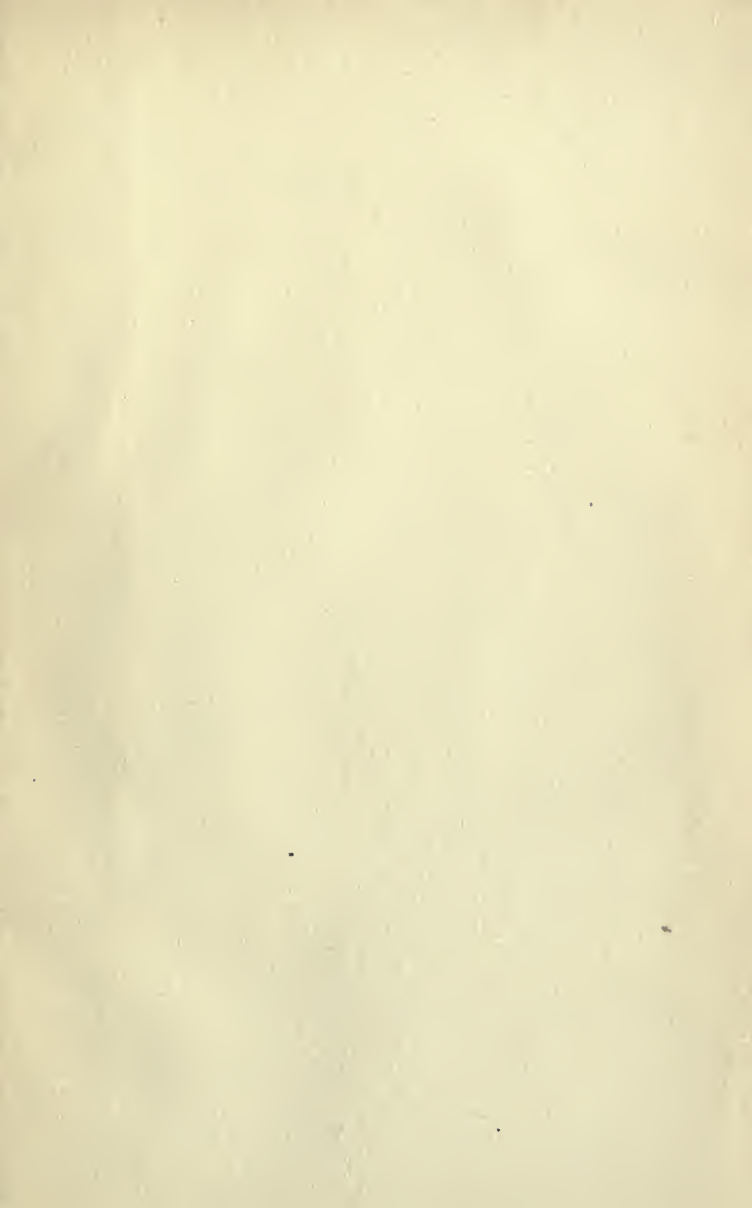
is submitted, we cannot afford to do at present when the War debt is so large. The danger of real inflation would come, however, when buyers of goods became convinced, as they no doubt soon would become convinced, that prices were not going to fall further. Orders would begin to be placed again for the markets other than those of the impoverished countries. The initial "Ways and Means" advance by the Bank of England would be leading to increases in the "cash at the Bank of England" of the other banks, and the question would be whether this would be allowed to become the basis of credits to five or six times this amount. It is submitted that that should be preventable, unless increase of goods available for consumption in England kept pace.

If the credits granted to impoverished countries led to the production at the end of say, twelve months, of goods such as sugar and wheat which were supplied to this country in repayment, the sale of these goods would enable the Government to extinguish its advance from the Bank of England. The existence of this advance for a period limited to say twelve months, involves some danger of undesirable inflation, but the fact that the period is so limited prevents that danger becoming serious.

If the credit had to be extended, however, for several years before repayment could be made, the danger of undesirable inflation would be the more serious, but still, it is submitted, that that undesirable inflation could be prevented by concerted action on the part of the banks to refrain from using the power put into their hands.

It may be remarked that if the same method were employed to finance the construction of roads, houses, etc., there would be a very similar, perhaps greater, risk of undesirable inflation, although goods desired by the British public were being produced, since, as remarked in an earlier note, the public would not buy the houses, etc., out of their incomes when they were produced. They might ultimately be purchased, but *ex hypothesi*, they are being constructed faster than the construction could be financed by normal savings.

In this case also, however, the real danger of inflation is after the depression producing unemployment has passed, and its occurrence should be preventible.





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